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No. 814

In the Supreme Court of the United States

OCTOBER TERM, 1939

CRAIG-JOHNSON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1939

No. 584

CRANE-JOHNSON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 14) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41) is reported in 105 F. (2d) 740.

JURISDICTION

The judgment of the court below was entered August 8, 1939 (R. 45). A petition for rehearing was denied September 15, 1939 (R. 46). The petition for a writ of certiorari was filed December 12, 1939. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The adjusted net income of the petitioner for the year 1936 was $12,032.72. As of January 1, 1936, the petitioner had a deficit of at least $21,251.40, the origin of the deficit not appearing. No distributions to stockholders were made during the year. A North Dakota statute prohibits the directors of a corporation from paying dividends except from surplus profits arising from the business. The questions presented are:

1. Whether the petitioner's charter or certificates of stock in conjunction with the North Dakota statute constitute a "written contract executed by the corporation" within the meaning of the credit provisions of Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether Section 26 (c) (1), as construed by the court below, violates the Fifth Amendment.

3. Whether the petitioner has shown that it was prohibited by state law from paying out all or a part of its current earnings as dividends.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 16–22.

STATEMENT

The facts were stipulated (R. 12–13) and found by the Board of Tax Appeals as follows (R. 14):

The petitioner was incorporated in 1903 under the laws of North Dakota (R. 12, 14).

As of January 1, 1936, the petitioner had a deficit of at least $21,251.40. The records prior to January 1, 1929, are not susceptible of analysis to show definitely

whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments. (R. 12, 14.)

No dividend distributions have been made by the petitioner since March, 1930, when $9,672 was so distributed from surplus balance existent at that time (R. 12).

The petitioner's net income for 1936 income tax computation purposes was $13,450.76. Its adjusted net income for 1936 was $12,032.72. (R. 13, 14.)

In its return for 1936, the petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,707.36 on undistributed profits, and asserted a deficiency in that amount. (R. 12–13.)

The Board of Tax Appeals sustained the Commissioner's action in disallowing the credit in question and in determining the deficiency (R. 21–22), and the Circuit Court of Appeals affirmed (R. 45).

ARGUMENT

1. The provisions of Section 26 (c) of the Revenue Act of 1936, *infra*, pp. 17–18, the interpretation of which is here involved, appear in no other Revenue Act, earlier or later, and accordingly the question presented in this case can arise only for the taxable years 1936 and 1937. The question is therefore not of importance except as it bears upon the disposition of matters now pending in the courts, the Board of Tax Appeals and the Treasury Department. The Board and the court below are the only tribunals which have passed upon the question, and they are in accord in sustaining the Treasury's

construction of the statutory provision. While other circuit courts of appeals will undoubtedly rule upon the interpretation of Section 26 (c) hereafter, there would seem, in the absence of a present conflict, to be no impelling reason for this Court to review this case.[1] And, as shown *infra*, pp. 14–15, even if the petitioner's interpretation of the statute be accepted petitioner could not prevail in this case.

2. Section 14 (b) of the Revenue Act of 1936, *infra*, pp. 16–17, imposes a graduated surtax upon corporations computed on such portion of the undistributed net income as is in excess of certain percentages of the adjusted net income. The term "adjusted net income" is defined in Section 14 (a) (1) as the net income less certain credits, and the term "undistributed net income" is defined as the adjusted net income minus the sum of the dividends-paid credit provided in Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends and debt payments.

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[1] The question is now under advisement by the Circuit Court of Appeals for the Ninth Circuit in *Northwest Steel Rolling Mills* v. *Commissioner*, argued on December 5, 1939, on review from an unreported decision of the Board of Tax Appeals. The question is presented in two cases in the district courts, neither of which has yet been decided. *Bastian Bros. Co.* v. *McGowan*, Collector (W. D. N. Y.), motion to dismiss argued on December 11, 1939; and *Utah Hotel Co.* v. *Hinckley* (Utah). The Board has also decided the question in two other cases: *McBrides, Inc.* v. *Commissioner*, unreported memorandum opinion delivered June 20, 1939 (time for appeal has expired); and *Co-operative Publishing Co.* v. *Commissioner*, 40 B. T. A. 465 (time for appeal expires January 26, 1940).

Insufficient time has precluded inquiry of the Treasury Department as to the number of cases pending there.

Section 26 (c) (1) provides for the allowance of a credit to the extent of—

> An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

The petitioner contends that since its books showed a deficit of $21,251.40 and earnings for 1936 of only $13,450.76, it was prohibited by North Dakota statutes [2] from distributing any dividends during that year and that the statute constituted a part of its charter, which was a written contract with the state and with its stockholders. It argues, therefore, that under Section 26 (c) (1) there were no amounts which could be distributed within the taxable year as dividends without violating the provisions of a written contract executed by the corporation prior to May 1, 1936; and hence that it is entitled to a credit equal to the entire amount of its 1936 earnings.

We do not deny that for some purposes a charter of a corporation is said to be a contract with the state, or that the state corporation laws are for some purposes regarded as a part of that contract. See e. g., *Dartmouth College* v. *Woodward,* 4 Wheat. 518; *Home Bldg. & L. Assn.* v. *Blaisdell,* 290 U. S. 398. The question

[2] Section 4543 of the North Dakota statutes *infra*, pp. 19–20, prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." Section 4544, *infra*, p. 20, imposes civil liability on directors who violate this provision.

here, however, is whether the charter and the state laws together are a written contract executed by the corporation within the meaning of Section 26 (c) (1) of the Revenue Act of 1936.

Corporate charters are secured through the filing of articles of incorporation by individuals desiring to incorporate and the issuance of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued and it obviously does not file the articles of incorporation. Hence the charter is not a written contract which the corporation itself has entered into and executed, even though it may subsequently be bound by its terms. And the statute here involved requires that there be a *written contract executed by the corporation.* The charter does not fulfill that condition.

In this case, moreover, the charter itself contained no provision restricting dividend payments. It is necessary to look to the statutes of North Dakota for the restriction. It seems obvious that a state law is not a written contract executed by the corporation, even though the corporation is bound by the statute and for that purpose it may be regarded as a part of its charter.

Practical considerations also indicate that Congress did not intend Section 26 (c) (1) to apply to charters and state statutes restricting the payment of dividends. Such statutes often differ widely in their wording, and different courts give diverse constructions to similarly worded provisions. The state courts differ, for example, in their treatment of appreciation, reserves for

replacements, depletion, accounts and loans receivable, and many other items.[3] If Section 26 (c) (1) is construed as referring to state laws restricting payment of dividends the Bureau of Internal Revenue will be required to determine in each case what the state law is, how it is administered in practice, and whether the particular corporation was so circumstanced that a payment of dividends by it would have violated the state law. This would impose an enormous burden upon the Bureau and one which Congress could scarcely have intended.

The legislative history of the undistributed profits tax provisions of the Revenue Act of 1936 supports the view that Congress did not intend to give special treatment to corporations which had deficits and were prohibited by state law from distributing dividends. The bill as introduced in the House contained three distinct provisions designed to relieve corporations which had a deficit or which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without dimunition by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was

[3] Many of the distinctions are pointed out in a series of articles entitled "Theory of Anglo-American Dividend Law," by Weiner, 28 Col. L. Rev. 1046, 29 Col. L. Rev. 461, and 30 Col. L. Rev. 330, 954. See also II Cook on *Corporations*, 8th ed., Sec. 546.

intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations having outstanding contracts not to pay dividends, and Section 16 was intended for the relief of corporations having an outstanding indebtedness (H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15, and 16).

The Committee on Finance of the Senate substituted for the graduated undistributed profits tax a flat surtax of 7 percent on undistributed profits. It also struck out Sections 14, 15, and 16 of the House bill, but in Section 26 (c) (1) retained the principle of Section 15 of that bill affording relief to corporations under contract not to pay dividends. An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contract to pay indebtedness which had been contained in Section 16 of the House bill. See Section 26 (c) (2) of the Revenue Act of 1936, *infra,* pp. 17–18; 80 Cong. Rec., part 8, pp. 8790–8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had adopted. But no provision for the relief of deficit corporations analogous to Section 14 of the House bill was restored to the bill. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2–4. See also Cong. Rec., *supra,* p. 9071.

By a change in the definition of a dividend in Section 115 (a) of the Revenue Act of 1934 (see Section 115 (a) of the Revenue Act of 1936, *infra,* pp. 18–19), the bill as passed allowed dividends-paid credit to deficit corporations which actually distributed current earnings (see Section 27 of the Revenue Act of 1936);

but none was allowed to deficit corporations which did not distribute.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had a deficit and were prevented by state law from paying out dividends appears to have been deliberate. Section 14 of the House bill would have given them relief but the bill as finally enacted did not do so. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a) the Committee on Finance said (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18):

> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividend paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

Attention is also called to the fact that Senator Walsh, a member of the Senate Finance Committee, stated on the floor of the Senate that the bill did not afford relief to corporations which were prevented by state law from declaring dividends except from earn-

ings. His statement was as follows (80 Cong. Rec., part 8, p. 9058):[4]

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

The petitioner quotes (Pet. 23–24) an excerpt from the minority views of Senators George and Walsh (80 Cong. Rec., part 10, p. 10164), and suggests that apparently Senator Walsh, subsequent to the above statement on the floor of the Senate, had been told that he was wrong in thinking that no relief was afforded to corporations which were prevented by state law from declaring dividends except from earnings. That Senator Walsh had not changed his views, however, is clearly shown by the following statement made by him several paragraphs after the one quoted by the petitioner (80 Cong. Rec., p. 10164):

> Even if there were no valid objections in principle to this measure, nevertheless there has not been sufficient study made to enable the Congress to provide—through exemptions—relief to the

[4] In the hearings before both Committees of Congress, attention was repeatedly called to the situation of companies located in such states. Hearings before the Committee on Ways and Means, House of Representatives, 74th Cong., 2d Sess., pp. 101–102, 836–837, 842, 846–847; Hearings before the Committee on Finance, United States Senate, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 251–262, 269, 282, 417.

following classes of business concerns which are distinctly penalized:

1. Those with deficits.

* * * * *

In addition the following business concerns are undoubtedly discriminated against:

* * * * *

3. Those prohibited by State laws from making dividend distribution if their capital is thereby impaired. Thirty-six States have such laws prohibiting directors from declaring dividends under such circumstances.

It should also be noted that when the bill which subsequently became the Revenue Act of 1938 was reported to the House of Representatives, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the Revenue Act of 1936 was that it was unfair to corporations with impaired capital which under state law cannot legally declare dividends. It was for that and other reasons that Congress substantially modified the undistributed profits tax imposed by the Revenue Act of 1938. (H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3–4.) No provision analogous to Section 26 (c) (1) appears in that Act, but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28 of that Act. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra*, p. 24):

SECTION 28. CONSENT DIVIDENDS CREDIT

One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that

> many corporations, for a variety of reasons, find it difficult, if not impossible, in certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

The legislative history of the Act thus supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that Congress did not consider that the provisions granting relief to corporations having a written contract executed by them not to pay dividends afforded relief to corporations prohibited by state law from making distributions except from earnings.

The Bureau of Internal Revenue has consistently held that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) of the Revenue Act of 1936. Article 26–2 of Regulations 94, *infra*, pp. 20–22, promulgated under the statute here involved, so provides. See also T. D. 4674, XV–2 Cum. Bull. 53, 58 (1936). In I. T. 3016, XV–2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to special treatment under Section 26 (c) (1).

If, therefore, the taxpayer was in fact prohibited by the state law from distributing its 1936 earnings, it is nevertheless not entitled to any credit under Section 26 (c) (1).

3. The petitioner contends (Br. 19–22) that if Section 26 (c) (1) be construed as not including cases where a corporation is forbidden by state law from paying dividends it violates the Fifth Amendment because based upon an arbitrary classification.

We question whether any failure to provide for a deduction or credit could violate the Fifth Amendment, since all deductions are discretionary with Congress. But if we are wrong in that view, we submit that there was a rational basis for the distinction made here between contracts not to pay dividends and state laws prohibiting the payment of dividends under certain conditions. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a written contract prohibits the payment of a dividend. But, as we have hitherto suggested, it would greatly burden the Bureau to have to determine the applicability in each case of the particular state statutes restricting the payment of dividends. That would involve not only an examination of the state law and practice, but also the entire financial history of every corporation. Taxing statutes must yield sometimes to the exigencies of administration (see *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365), and the income tax laws do not profess to embody perfect economic theory (*Helvering* v. *Midland Mutual Life Ins. Co.*, 300 U. S. 216, 225). The Constitution does not require

precise and scientific uniformity in taxing statutes. *Welch* v. *Henry*, 305 U. S. 134; *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282.

4. Even if Section 26 (c) (1) were susceptible of the construction which the petitioner places upon it, we submit that the petitioner has not shown that it was prohibited by state law from paying out all or a part of its current earnings as dividends, and hence that it is not entitled to reduce the net income subject to the tax by the amount of those earnings.[5]

It was stipulated that as of January 1, 1936, the petitioner had a deficit of $21,251.40, but that its records prior to January 1, 1929, were not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments (R. 12). No dividend distributions had been made by the petitioner since March, 1930, when $9,672 was distributed from then existing surplus (R. 12).

Section 4543 of the North Dakota statutes (*infra*, pp. 19–20) prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." But the taxpayer here has not sustained the burden of proving that it had such a deficit as would have prohibited the payment of dividends.[6] For example, we do not know whether or not the deficit resulted from prior capital

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[5] Neither the Board nor the court below found it necessary to pass upon this point, although it was presented to both.

[6] In *Lark Equity Exchange* v. *Jones*, 42 N. D. 145, it was held that a corporation seeking to recover dividends claimed to have been paid in violation of Section 4543 [illegible] the burden of proving that an actual deficit existed.

distributions, and there is considerable authority that in determining the profits available for dividends it is immaterial that some portion of the capital has been lost in a prior year and has not since been made good. II Cook on *Corporations,* 8th ed., Sec. 546, pp. 1895–1906.[7] The fact that the books of the petitioner showed a deficit is thus not conclusive that the distribution of the 1936 earnings as a dividend was prohibited under the North Dakota statutes.

CONCLUSION

There is no conflict of decisions, the question presented is not of great importance, and the decision below is probably correct. It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. JACKSON,
Solicitor General.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

SEWALL KEY,
LEE A. JACKSON,
Special Assistants to the Attorney General.

THOMAS E. HARRIS,
Attorney.

JANUARY, 1940.

[7] We have found no North Dakota cases dealing with this question.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specific Credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such

credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the tax-

able year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

North Dakota Compiled Laws—Supplement—(Annotated), 1913–1925:

SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; provided, however, that the above limitation as to the creation of debts shall not apply to the policy risks of insurance companies on which no loss has occurred, or the notes, bonds or debentures of any loan or trust company or public utility, company or corporation, organized under the provisions of this chapter, when payment of such notes, bonds or debentures shall be secured by the actual transfer of real estate by trust deed or mortgage for the payment of such notes, bonds or debentures, which said real estate so transferred shall be of twice the value of the par value of such notes, bonds and debentures; provided further that the limitation as to the value of property conveyed by trust, deed or mortgage shall not apply to the bonds or debentures of public-utility corporations; provided, further, that such limitation shall not apply to any loan or trust company's guarantee of payment after transfer of any note, bond or debenture when the same is secured by trust deed or mortgage as above stated; provided, further that the above limitation as to the creation of debts shall not apply to certificates and debentures

issued by investment companies for the creation of an investment fund where the holder of such certificates or debentures shall by the terms of the same, participate in the earnings of such investment fund. (Laws 1925, ch. 109, § 1.)

SEC. 4543a. *To what corporations applicable.*—The provisions of this act shall apply to corporations heretofore and hereafter organized. (Laws 1925, ch. 109, § 2.)

SEC. 4544. *Penalty for violation of statute.*—For a violation of the provisions of the last section (§4543), the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the directors at the time, or were not present when the same did happen, are in their individual and private capacity, jointly and severally liable to the corporation, and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced, or debt contracted. There may, however, be a division and distribution of the capital stock of any corporation which remained after the payment of all its debts, upon its dissolution or the expiration of its terms of existence. No action or proceeding to enforce or recover any penalty, forfeiture or liability hereunder shall be commenced more than six months after the aggrieved party shall have had actual notice of the violation of the preceding section (§4543). (Laws 1919, ch. 100, §1.)

Treasury Regulations 94 (1936 ed.), promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of divi-

dends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1), and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*— The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends.

If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

The computation of the credit allowable under section 26 (c) (1) may be illustrated by the following examples:

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